EFFECTIVENESS OF INTERNAL CONTROL SYSTEM IN FINANCIAL INSTITUTIONS

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Abstract

The need to continuously track and monitor the compatibility of all banking practices and operations with laid down procedures, standards, banking laws, regulations and rules to solve problems that may arise where necessary necessitates this research work. In view of this therefore, this study seeks to examine the effectiveness of internal control system in Nigerian Banks. Internal control system covers all assessment and methods that are adopted in an organization to detect the suitability of operations in accordance with policies determined by management, implementing a chart of accounts and reporting system, specifying the duties, authority and responsibilities of the organization. The study recommends that banks should put in place a strong internal control system to ensure that the bank's assets are safeguarded and its overall goals and objectives are achieved.

Introduction

Internal control is the set of accounting, administrative controls and practices that help managers in operating their organizations more effectively and efficiently. It ensures that both the accounting and administrative activities are in order with laid down procedures, standards and statutory requirements. It also detects deviation, if any and calls for immediate corrective measure. According to Ogbunka (2002), internal control system is created by management and implemented by management and employees. It is a process designed to ensure reasonable assurance to achieve pre-specified objectives. In any profit oriented organization such as a bank for instance, the objective of management is to maximize profit and internal control is a technique that can be of assistance in attaining such maximizations. Banking is a venture undertaken primarily for profit and whose operation should at least include taking money on account and releasing of such money wholly or partly on demand or authority of the depositor. An important objective of banking particularly in the developing countries is the promotion of economic development. In pursuance of this economic development as well as banks' profitability, banks tend to improve on their services by devising methods of sound and effective system of internal control. Gamage and Fernando (2014) disclosed that the banking sector is a unique sector in any economy. It provides different kinds of services to customers and handles massive volume of funds daily. All activities in the economy depend on the strength and stability of the banking sector. Due to this fact, the necessity of internal control system in banks cannot be undermined. The basis of safe and sound banking system as well as effective internal controls is very important. A system of tough internal controls can support to ensure that the goals and objectives of banks will be met, that the bank will help to attain long-term profitability targets and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures and decrease the risk of unexpected losses or damage to the bank's reputation. This help bank's Board of Directors and management to safeguard the bank's resources, produce reliable financial reports and comply with laws and regulations. Meantime, it supports to reduce possibilities of substantial errors and irregularities and assists in their timely detection when they do occur. Also this control system may discover mistakes caused by personal distraction, carelessness, error in judgment or unclear instructions in addition to frauds or deliberate noncompliance with policies. Ozten (2012) disclosed that the main objective of internal control system for banks is to continuously track the compatibility of all banking practices and operations with international auditing standards, banking laws, regulations and rules to solve problems that may arise where necessary. In addition to this, with an effective internal control system, erroneous, fraudulent transactions and irregularities are less likely to happen in banks. In the context of the above background, the presence of effective internal control system and their use is very vital to banks which engage in broader financial, economic and social roles. No any argument therefore that every bank must have strong internal control system in practice.

Literature Review

Internal controls are policies, procedures, practices and organizational structures implemented to provide reasonable assurance that an organization's business objectives will be achieved and undesired risk events will be prevented or detected and corrected, based on other compliance or management initiated concerns (Awe, 2005). According to Robertson and Davis (1988), internal control system is a set of client procedures both computerized and manual, imposed on the accounting system of an organization for the purpose of preventing, detecting and correcting errors and irregularities that might enter the system and thereby affect the firm's financial statements. The Institute of Chartered Accountant of Nigeria (2006) defined internal control as the whole system of controls, financial or otherwise, established by management in order to carry on the business of an enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records. Mayo and BPP (1988) defined it as measures taken by an organization for the purpose of protecting its resources against wastes, fraud and inefficiency, thereby ensuring accuracy and reliability in accounting and operating data; securing compliance with organizational policies and evaluating the level of performance in all divisions of the organizations. From these definitions, it can be deduced that internal control comprises the plan of an organization and all of the coordinate methods and measures adopted within it to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. Internal control objectives are channelled towards ensuring adherence to managerial policies and achieving organizational goals in general.

Responsibilities of Internal Control Unit in Financial Institutions

The internal control unit in an organization is solely responsible for tracking the compatibility of all organizational practices and operations with prescribed standards, laws, regulations and rules to solve problems that may arise where necessary. In addition to this, with an effective internal control system, erroneous, fraudulent transactions and irregularities are less likely to happen. It is management's responsibility to set up an internal control unit in an organization in other to achieve these objectives. The role of management in any organization involves the planning and control of the operations of the organization to ensure that they are in accordance with plans (Walter and Will, 1982). The totality of this procedure is to ensure that the internal control system is effective on its operators. According to Oyejide and Soyode (1998), management has the responsibility under the Companies and Allied Matters Act (CAMA) to keep adequate accounting records. Management should therefore introduce appropriate controls to prevent or reduce the incidence of irregularities and intentional errors, including fraud. The risk of fraud can be reduced by ensuring that the key functions within each transaction cycle are always performed by separate individuals. Okoye (2009) observed that internal control is a process effected by the Board of Directors, Senior Managers, all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within an organization. The Board of Directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis; however each individual within an organization must participate in the process. The main objectives of internal control unit in any organization can be categorized as: Performance objectives for internal controls pertaining to the effectiveness and efficiency of the bank in using its assets and other resources and protecting the bank from loss. The internal control process seeks to ensure that personnel throughout the organization are working to achieve its goals with efficiency and integrity without unintended or excessive cost or placing other interest (such as an employee's, vendor's or customer's interest) before those of the bank (Olaye, 2009). Information objectives address the preparation of timely, reliable, relevant reports needed for decision-making within the banking organization. They also address the need for reliable annual accounts/report, other financial statements and other financial-related disclosures and reports to shareholders, supervisors and other external parties. The information received by management, the Board of Directors, shareholders and supervisors should be of sufficient quality and integrity that recipients can rely on the information in making decisions. The term reliability, as it relates to financial statements, refers to the preparation of statements that are presented fairly and based on comprehensive and well-defined accounting principles and rules (Olaoye, 2009). Compliance objectives ensure that all banking business complies with applicable laws and regulations, supervisory requirements and the organizations policies and procedures. This objective must be met in order to protect the bank's franchise and reputation.

Duties of Banks Staff in the Internal Control Process

According to the American Institute of Certified Public Accountants (2014), everyone in an organization has responsibility for internal control to some extent. Virtually all employees produce information used in the internal control system or take other actions needed to affect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions. Each major entity in corporate governance has a particular role to play. The duties of staff in internal control process include:

Management

The Chief Executive Officer (the top manager) of the organization has overall responsibility for designing and implementing effective internal control. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they are controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit's functions. In a smaller entity, the influence of the chief executive, often an owner-manager is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staff whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

Board of Directors

Management is accountable to the Board of Directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

Auditors

The internal auditors and external auditors of the organization also measure the effectiveness of internal control through their efforts. They assess whether the controls are properly designed, implemented and working effectively and make recommendations on how to improve internal control. They may also review information technology controls, which relate to the IT systems of the organization. There are laws and regulations on internal control related to financial reporting in various countries. In the U.S. for instance, these regulations are specifically established by Sections 404 and 302 of the Sarbanes-Oxley Act. To provide reasonable assurance that internal controls involved in the financial reporting process are effective, they are tested by the external auditor (the organization's public accountants), who are required to opine on the internal controls of the company and the reliability of its financial reporting.

Audit Committee

The role and responsibilities of the audit committee, in general terms, are to: (a) discuss with management, internal and external auditors and major stakeholders the quality and adequacy of the organization’s internal controls system and risk management process and their effectiveness and outcomes and meet regularly and privately with the head of internal audit; (b) review and discuss with management and the external auditors and approve the audited financial statements of the organization and make a recommendation regarding inclusion of those financial statements in any public filing. Also review with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet issues in the organization's financial statements; (c) review and discuss with management the types of information to be disclosed and the types of presentations to be made with respect to the company's earnings, press releases and financial information and earnings guidance provided to analysts and rating agencies; (d) confirm the scope of audits to be performed by the external and internal auditors, monitor progress and review results and review fees and expenses among others.

Operating Staff

All staff members should be responsible for reporting problems of operations, monitoring and improving their performance, and monitoring non-compliance with the corporate policies and various professional codes, or violations of policies, standards, practices and procedures. Their particular responsibilities should be documented in their individual personnel files. In performance management activities, they take part in all compliance and performance data collection and processing activities as they are part of various organizational units and may also be responsible for various compliance and operational-related activities of the organization. Staff and junior managers may be involved in evaluating the controls within their own organizational unit using a control self-assessment.

Strengthening Internal Control System in Financial Institutions

In view of the enormous growth in size and complexities, proper management of modern business undertakings is not possible unless they have an effective system of internal control. Hence, sophisticated systems of management information and control have been introduced in many organizations (Andrew-Essien, 2008). The evaluation of internal control system entails the assessment and appraisal of the system to determine its establishment. Though the system may be claimed to be effectively operational, however, there is the human tendency to relax from its compliance and gradually depart from the originally designed high standard of procedure. In other to strengthen internal control system in an organization therefore, the following must be considered as observed by Asukwo (2007):

Reliable Personnel with clear Responsibilities

Dishonest and incompetent workers can undermine a system. Individuals must be given authorities, responsibilities and duties commensurate with his abilities, and experience. The system needs constant surveillance and appraisal by management to determine if it is working according to the design and where some changes are warranted.

Separation of Duties

This ensures accurate compilation of data and limits the chances of fraud by collusion of two or more persons. Custody of assets should be separated from those accounting for them to reduce the temptation and fraud.

Proper Authorization

All transactions should be appropriately approved and executed in accordance with prescribed management guideline. For example, there is usually the need for approval from the board of directors for capital expenditure in excess of certain limit.

Adequate Documentation

Documentation such as sale invoices and receipts, requisition notes and purchase order should be pre-numbered and accounted for, by using devices such as cash registers and locked compartments in invoice writing machines and by designing forms for ease of recording.

Physical Safeguard

One of the ways to prevent losses of cash, inventories and records is by using safes, locks, watchmen and restrict access to them.

Independent Check

All phases of the system should be subjected to periodic review by independent persons, may be external auditors. Bank statements should be periodically reconciled with the book balances.

Limitations of Internal Control System

Internal controls are essential features of any organization that is non-effective. However no system of internal control can by itself guarantee efficient administration and the completeness and accuracy of the records nor can it be proof against fraudulent act especially in connection with those holding the position of authority. According to Oyejide and Soyade (1998), the inherent limitations of internal control include:

1. Management overdoing controls whenever the control does not suit their selfish ambitions.
2. Fraud committed by someone who has carefully studied the system of a particular organization
3. Abuse of responsibility i.e. taking advantage of the position held to do or carryout illegal acts.
4. Cleverness of some people who specialize in gelding computer codes of an organization which are designed to prevent public access, no matter how secure they might be.
5. Employees of an organization making potential human errors caused by sheds of excess works, alcohol, carelessness, distractions etc.
6. All these are factors that can limit the effectiveness of internal control system in the financial management of an organization.

Conclusion

This study has examined the effectiveness of internal control system on banks' survival. Based on empirical analysis carried out, it is concluded that internal control system is a necessity to ensure effective and efficient operations in banks. Hence, it is not possible for an organization not to maintain a good internal control system. Furthermore, internal control system plays a significant role in the profitability of banks. This is premised on the fact that profit maximization is dependent on the effective and efficient internal control system that runs in such bank. The nature of the internal control system in an organization is determined by the volume of business operations and size of the firm. Lastly, the nature of internal control system in an organization is dynamic such that it changes overtime in order to meet-up with current societal trends.

Recommendations

The following recommendations are suggested in other to further strengthen internal control in any organization:

i. Controls must be comprehensive enough to cover all finances and operations; i.e. there must be exhaustive checks and balances. The essence of this is to curtail the menace of fraud and loss of revenues.
ii. Staff should be given adequate training on the legal implication of circumventing any type of control. This will help to create more awareness on the members of staff.
iii. A system of strong internal controls can help to ensure that the goals and objectives of banks will be met, thereby achieving long-term profitability targets and maintaining reliable financial and managerial reporting.
iv. Operational guidelines on internal control, risk management, deposits and other accounts, personnel, wages and salaries, cash and cheques must be strictly followed by all and sundry.

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